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Supreme Court, U.S.
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NO. 05-1294

IN THE SUPREME COURT OF THE UNITED STATES

MCLANE WESTERN, INC.,
Petitioner

vs.

COLORADO DEPARTMENT OF REVENUE, STATE OF COLORADO; AND M. MICHAEL COOKE AND FRED FISHER, AS THE EXECUTIVE DIRECTORS OF THE DEPARTMENT OF REVENUE OF THE STATE OF COLORADO

Respondents.

On Petition for Writ of Certiorari to
The Colorado Court of Appeals

BRIEF OF THE RESPONDENTS IN OPPOSITION TO PETITION FOR WRIT OF CERTIORARI

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QUESTION PRESENTED

Colorado imposes a tax on the price paid by the first Colorado distributor for certain tobacco products. Depending on the distributor's business practices, this price may be paid to a manufacturer or a supplier. The price paid to a supplier will generally be higher, reflecting markups added throughout the product distribution chain. The question presented is whether the state's imposition of this tax on a supplier's price violates the United States Constitution's grant to Congress of the power "[t]o regulate Commerce . . . among the several States." U.S. Const. art. I, § 8, cl. 3.

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STATEMENT

1. Counterstatement of the Facts

Petitioner McLane's statement of the factual background omits important information regarding the relationship between the supplier and the manufacturer from which McLane bought "other tobacco products" ("OTP") during the periods at issue. Before 1990, McLane purchased OTP from the United States Tobacco Company ("USTCo."). Pet.'s Appendix A at 2a. At that time, USTCo. sold OTP to unaffiliated distributors such as McLane. *Id.* USTCo. performed three functions: manufacturing OTP, marketing it, and selling it. *Id.* In January 1990, USTCo. reorganized and formed two wholly-owned subsidiary companies, United States Tobacco Sales & Marketing Company, Inc. ("UST Sales") and United States Tobacco Manufacturing Company, Inc. ("UST Manufacturing"). *Id.*

The subsidiaries' parent company, USTCo., changed its name to U.S. Smokeless Tobacco Company ("US Smokeless"). *Id.* UST Sales assumed USTCo.'s marketing and sales functions while UST Manufacturing assumed USTCo.'s manufacturing function. *Id.* UST Sales purchased OTP exclusively from its affiliate, UST Manufacturing. Pet.'s Appendix B at 16a, ¶¶ 5, 7. UST Sales then sold the OTP to distributors such as McLane. *Id.* at 16a, ¶ 5. After USTCo.'s reorganization, McLane continued to purchase OTP from USTCo., but through its affiliate, UST Sales. Pet.'s Appendix A at 2a. For all the refund periods in dispute, McLane purchased OTP exclusively from UST Sales. *Id.*

UST Sales sold OTP to McLane at a higher price than UST Manufacturing sold the same OTP to its affiliate, UST Sales. *Id.* at 2a. McLane explains the higher price as

reflecting the costs specific to UST Sales' marketing and selling functions. *Id.*; *see also* Pet.'s Appendix B at 16a, ¶ 8. The implication is that, in the pre-1990 OTP transactions, when USTCo. (now U.S. Smokeless) sold OTP to McLane, the price: (1) included the costs associated with manufacturing as well as those associated with marketing and selling since, at the time, USTCo. performed all three functions, and (2) was not significantly different from the price for which McLane purchased the OTP from UST Sales. McLane never challenged these assumptions throughout the state court proceedings.

McLane buys, resells, and ships grocery products, OTP among them, throughout the Western United States, including Colorado. Pet.'s Appendix A at 1a. McLane initially calculated its OTP tax liability using, as the law requires, the price it actually paid for the OTP, which was the invoice price of the supplier, UST Sales. At some point, however, McLane had the revelation that it could lower its tax liability by basing its calculation not on the price it actually paid, but on the lower manufacturer's invoice price that UST Manufacturing charged its own affiliate, UST Sales. Pet.'s Appendix B at 17a, ¶¶ 9-10; 18a, ¶ 13. The difference in these invoice prices is the basis for McLane's refund claims. *Id.*

2. Counterstatement of Colorado's OTP-Tax Scheme.

McLane fails to adequately explain the manner in which Colorado imposes its OTP tax on the price a distributor pays in order to purchase OTP. Colorado imposes a tax on the "manufacturer's list price" for OTP when a distributor first performs any one of three incidences of taxation related to the distribution of OTP that are listed in Colo. Rev. Stat. § 39-28.5-102(1)(a)-(c): bringing OTP into the state for sale, manufacturing OTP in the state, or

transporting OTP to retailers in the state. McLane concedes that it performs at least two of these activities and is therefore liable for the tax associated with its OTP purchases from UST Sales. Pet.'s Appendix A at 3a.

Colorado law defines "manufacturer's list price" as "the invoice price for which a manufacturer *or supplier* sells a tobacco product to a distributor exclusive of any discount or other reduction." Colo. Rev. Stat. § 39-28.5-101(3) (emphasis added). *See also* Pet.'s Appendix A at 4a. The statute includes this dual specification to ensure that companies cannot avoid their obligation to pay the tax simply by reorganizing into separate manufacturing and supply subsidiaries, as USTCo. did. The statutory structure therefore seeks to achieve the same result no matter what the structure of the manufacturing and supply system from which a distributor purchases OTP—that is, the law seeks to impose the tax on the price actually paid for OTP by the taxable distributor. Many other states impose an OTP tax in a similar manner.[1]

Under this system, determining the tax base requires only ascertaining what price the distributor responsible for the OTP tax paid for OTP. In this case, McLane, the party admittedly responsible for paying the OTP tax, purchased OTP from UST Sales. Pet.'s Appendix B at 18a, ¶ 13. McLane paid UST Sales for OTP, and UST Sales provided McLane an invoice for OTP. *Id.* at 17a-18a, ¶¶ 12, 13. Accordingly, pursuant to Colorado's definition of

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[1] *See, e.g.*, Cal. Rev. & T. Code § 30011.7 (OTP tax imposed on the cost of tobacco products the taxable distributor pays for OTP); Md. Tax–General Code Ann. § 12-101(g) (tax imposed on the price the taxable wholesaler pays for OTP); Neb. Rev. Stat. § 77-4008 (the tax is imposed on the purchase price paid by the OTP's first owner); N.M. Stat. Ann. §§ 7-12A-2, 7-12A-3 (the tax is imposed on the "product value," which means the amount paid for the OTP); N.C. Gen. Stat. § 105-113.4(2) (tax imposed on the price paid for OTP by the taxable person); Or. Rev. Stat. Ann. § 323.500(15) (tax imposed on price paid for untaxed tobacco products), and W. Va. Code §§ 11-17-2, 11-17-3 (if the taxpayer purchases OTP from any one other than a manufacturer, the tax is imposed on the invoice price paid by the taxpayer).

"manufacturer's list price," the invoice price paid by McLane determined its OTP tax. McLane has never purchased OTP from UST Manufacturing; therefore, whatever price UST Manufacturing might charge *its sister subsidiary is not* relevant to calculating McLane's tax liability.

REASONS FOR DENYING THE WRIT

The decision of the Colorado Court of Appeals is correct and does not conflict with any decision of this Court or the courts of any other state. Further review is therefore not warranted. The central premise of McLane's claim is that an earlier sale and purchase of OTP between UST Sales and UST Manufacturing, a sale not involving the undisputed taxpayer, McLane, somehow should determine the tax base upon which McLane calculates its OTP-tax liability. Basing a taxpayer's burden on an ancillary transaction that does not involve the taxpayer would be novel in the area of transactional and excise taxes. Nothing in the Commerce Clause or this Court's precedent requires or justifies such a strange result.

I. The Colorado Decision Does Not Discriminate Against Interstate Commerce And, Therefore, Does Not Raise A Constitutional Question.

A. Colorado's OTP-Tax Scheme Focuses On The Actions Of In-state Distributors And Those Distributors' Performance Of In-state Incidences Of Taxation Rather Than On The Actions Performed By Out-Of-State Suppliers.

The Petition asserts that "[t]he disparate treatment of in-state and out-of-state economic interests that benefits the former and burdens the latter is undisputed in this case." Pet. at 9. This is simply untrue. It is undisputed that in some hypothetical cases the OTP-tax system would tax in-state OTP manufacturers at a lower base than it would tax in-state distributors. But the Respondents have consistently argued that the general effect of the OTP tax is not to favor in-state economic interests. Indeed, as will be shown below, it is at least as likely that the high levels of taxation of in-state activity related to the manufacture, sale, and distribution at issue here serves to discourage such activity in Colorado.

The record contains no evidence that any OTP manufacturers exist in Colorado. Though the case does not turn on this fact, it is unlikely that the state created this scheme to benefit nonexistent entities. The facts, as clarified above, show that Colorado's OTP-tax scheme is structured so tobacco manufacturers, suppliers, and distributors cannot avoid their liability simply by effecting artificial corporate reorganizations. Despite McLane's efforts to paint Colorado's OTP-tax scheme as a jumble of "shifting tax

bases," the scheme is, in fact, a straightforward transaction tax. Like any other such tax, it applies only to the activities of those doing business within the jurisdiction of the taxing entity.

To determine liability under the OTP-tax scheme, two questions must be answered. First, who is liable for the tax? The answer is the distributor who first brings OTP into Colorado, manufactures OTP in Colorado, or transports OTP to retailers in Colorado. *See* Colo. Rev. Stat. § 39-28.5-102(1)(a)-(c). Once the entity liable for the tax is determined, the second question is simple: What did that entity pay for the OTP? *See id.* §§ 39-28.5-101(3); -102(1).

It is obvious from these questions that the location of an entity is relevant only in answering the first question: Who pays? This answer must take into account whether an activity is taking place inside or outside Colorado, not for discriminatory purposes but for simple jurisdictional ones. Colorado does not seek to tax out-of-state activities. Apparently conceding this, McLane's entire petition focuses on the second question: How much? But in answering this question, the location of the entities is irrelevant. All that matters is the price McLane paid for the OTP. The fact that USTCo.'s reorganization resulted in one out-of-state affiliated company charging another a lower price than McLane pays does not change the fact that Colorado must tax the actual invoice price paid by McLane, the in-state distributor.

The OTP tax does not violate the test established by this Court in *Complete Auto Works v. Brady* 430 U.S. 976, 97 S. Ct. 1669 (1977). In that case, this Court ruled that a state can impose its transaction taxes on activities that cross state borders as long as the activities do not discriminate against interstate commerce. *Id.* at 279. The Colorado Court of Appeals' construction of Colorado's OTP-tax scheme ensures that the tax base is determined by the OTP purchase

price paid by the in-state entity that performs one of the three incidences of taxation (who then owes the tax) and therefore has nexus with Colorado sufficient to the state's compelling compliance with its OTP-tax scheme in a constitutionally permissible manner. The OTP-tax scheme's focus on in-state incidences of taxation places the responsibility for paying the OTP tax on in-state distributors rather than those of out-of-state suppliers. It does this in order to tax in-state incidences of taxation rather than to tax OTP as it enters Colorado as part of interstate commerce or tax the distribution network itself. Pet.'s Appendix A at 8a.

Contrary to McLane's assertions, the proper application of the Court of Appeals' construction of the OTP-tax scheme does not depend on whether the supplier or manufacturer resides inside or outside Colorado, or whether the sale of OTP to a Colorado distributor was consummated inside or outside the state. The proper application depends on identifying: (a) the single in-state distributor that pays the OTP tax on a particular transaction, and (b) what price that tax-liable distributor pays for the OTP. The Court of Appeals correctly concluded this when it held that "[a]ll taxable distributors of OTP are taxed at the same rate and on a tax base determined in the same fashion." *Id.*

B. Colorado's OTP-Tax Scheme Does Not Favor In-state Economic Interests Over Out-Of-State Interests.

McLane mistakenly asserts that the Court of Appeals' interpretation of Colorado's OTP-tax scheme discriminates against interstate commerce by favoring in-state economic interests over out-of-state interests. Pet. at 14. The Court of Appeals correctly concluded that "neither [UST] Manufacturing nor [UST] Sales is encouraged to move into [Colorado] because they might well become the

taxable distributor." Pet.'s Appendix A at 8a. The court is correct.

If anything, the OTP scheme would discourage OTP manufacturers and suppliers from moving to Colorado. Were an OTP manufacturer or supplier to do so, pursuant to the mandates in *Quill Corp. v. North Dakota*, 504 U.S. 298 (1992), its presence in Colorado would subject it to the state's taxing authority. To particularize the hypothetical, if UST Manufacturing (or UST Sales) moved to Colorado, it would become the taxable distributor under Colo. Rev. Stat. §§ 39-28.5-101(2) and -102. Perhaps this explains the apparent paradox in McLane's argument, which hinges on Colorado's discriminating in favor of an in-state industry that does not exist.

McLane premises its assertions on the Court of Appeals' acknowledgement that, since the OTP tax is calculated using the OTP's purchase price, OTP purchased and taxed at the end of a long distribution supply chain will have a higher price and a resultant higher tax than OTP purchased and taxed at the end of a short distribution and supply chain. Pet. at 7, 14. It is true that, as the OTP passes through a supply chain, the OTP's ultimate taxable price accumulates middlemen's markups. Accordingly, as the Court of Appeals concluded, a product that has a higher sales tax because of a long distribution and supply chain will likely be at a competitive disadvantage to one that has a lower sales tax due to a shorter distribution and supply chain. Pet.'s Appendix A at 8a. But the Court of Appeals correctly held that, because the competitive disadvantage is a product of McLane's decision to purchase OTP through a distribution supply chain rather than directly from a manufacturer, this disadvantage does not violate the Dormant Commerce Clause. In other words, the court correctly concluded that the higher tax McLane wishes to

avoid is of its own making and a product of its own OTP purchasing model, not Colorado's OTP-tax scheme.

A similar competitive disadvantage arises in the context of another excise tax—that is, the sales and use tax. Taxing jurisdictions impose their sales tax on the price at which retailers sell their product to the ultimate consumer.[2] The retail purchase price, like OTP's purchase price, reflects an accumulation of markups imposed by middlemen suppliers (called wholesalers) as the product passes through the distribution and supply chain. The fewer the middlemen, the lower the price the retailer charges its customers and the lower the sales tax associated with the sales price. There is nothing unconstitutional about imposing transactional taxes, including the OTP tax, on a marked-up price.

Correctly viewing Colorado's OTP-tax scheme reveals that it and the decision upholding it are not blueprints by which states can construct discriminatory and, therefore, unconstitutional transactional-tax systems. The scheme is a rational way for states to combat companies' continuing attempts to avoid or limit their state tax liabilities through creative and sometimes questionable tax planning.

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[2] *See, e.g.*, Colorado's sales- and use-tax scheme which defines "purchase price" as the price charged the consumer and as the amount of money received or due in order to purchase a product or taxable service. Colo. Rev. Stat. § 39-26-102(7)(a) and 1 Colo. Code Regs. 201-4 § 26-102.7(a)(1). *See also* the *Streamlined Sales and Use Tax Agreement*, Appendix C, p. 83 (Nov. 12, 2002) (available at <http://www.streamlinedsalestax.org/Final%20Agreement%20As%20Amended%2001-13-06.pdf>), which defines "sales price" as the amount of money for which goods and property are sold and includes the price the seller paid for the property and the seller's service costs. In both these examples, the taxable price would include the seller's mark-up.

II. There Is No Conflict With This Court's Decisions.

A. The Ruling Below Does Not Conflict With Halliburton Oil Well Cementing Co. v. Reily.

McLane mistakenly asserts that the Court of Appeals' decision "is contrary to" the holding in 373 U.S. 64 (1963). Pet. at 10. In *Halliburton Oil Well Cementing Company v. Reily*, 373 U.S. 64, 83 S.Ct. 1201 (1963), the taxpayer manufactured or assembled custom oil field equipment outside Louisiana. The state imposed a use tax on custom-made equipment manufactured outside Louisiana and brought into the state for use. The tax on the out-of-state equipment was based on the total cost of manufacturing and assembling the equipment, including labor and shop overhead. However, the taxable price of equipment manufactured in Louisiana did not include these added costs. In addition, second-hand equipment was taxed differently based on whether it was purchased in or out of the state. This Court held the tax unconstitutional because it discriminated against out-of-state businesses and encouraged businesses to move into the state.

Colorado's OTP-tax scheme, however, does not pressure out-of-state businesses to move to Colorado. In fact, as discussed above, the opposite may well be true. It may be helpful to consider how, exactly, the facts in *Halliburton* would have to be adjusted for it to be the twin of the case at hand. Louisiana would have to have had a consistent tax rate based on the price paid for goods brought from outside the state for sale in Louisiana. The plaintiff would have to have claimed that its tax liability should be based not on the price it paid for the goods, but on some lower price paid by another entity outside the state. The other entity would have to be an affiliate of the company from which the plaintiff

actually bought the goods, and the three would have had exclusive sales contracts with one another. Needless to say, this Court would not have analyzed this hypothetical case in a way remotely similar to the way it analyzed the real facts in *Halliburton*.

Another hypothetical scenario demonstrates the type of shifting tax base that McLane complains would violate the holding in *Halliburton*. Assume for example that Colorado's OTP-tax scheme provided that in-state distributors must use the manufacturer's invoice price in order to calculate their OTP taxes, but that out-of-state distributors with Colorado nexus must use the supplier's invoice price to calculate their taxes. Also assume that this statutorily mandated use of different tax bases resulted in in-state distributors paying a tax lower than the out-of-state distributors. This would be a shifting tax base, and it would violate the holding in *Halliburton* and the Dormant Commerce Clause because it would give in-state distributors a tax advantage over out-of-state distributors with Colorado nexus. In other words, in this hypothetical, Colorado's OTP-tax scheme would mandate a competitive advantage for in-state distributors.

In actuality, however, Colorado's tax scheme does not mandate a disparity in the treatment of distributors similar to that addressed in *Halliburton*. The Court of Appeals correctly determined that "[a]ll taxable distributors of OTP are taxed at the same rate and on a tax base determined in the same fashion." Pet.'s Appendix A at 8a. The shifting tax base about which McLane complains is a result of its decision to purchase OTP via an artificial supply chain, not a product of Colorado's OTP-tax scheme. The Colorado Court of Appeals correctly ruled that *Halliburton* does not conflict with its decision. Pet.'s Appendix A at 9a-10a.

B. The Ruling Below Does Not Conflict With *Armco Inc. v. Hardesty*.

McLane mistakenly asserts that the Court of Appeal's decision violates the holding in *Armco, Inc. v. Hardesty*, 467 U.S. 638 (1984). Pet. at 16-18. In *Armco, Inc.*, this Court struck down West Virginia's gross receipts tax as discriminating against interstate commerce because the state exempted in-state manufacturers from gross receipts tax when they sold their locally manufactured products in West Virginia, but required out-of-state manufacturers who had nexus with West Virginia to pay the tax when they sold in the state products manufactured outside the state. *Id.* at 639, 640. Colorado's OTP-tax scheme does not discriminate because, unlike the tax scheme at issue in *Armco*, it does not distinguish between local, in-state distributors and out-of-state distributors. All similarly situated tax-liable distributors are treated the same.

This type of tax-imposition scheme satisfies the mandates of the Dormant Commerce Clause. All in-state distributors and the out-of-state distributors with Colorado nexus are liable for the OTP tax. Colorado does not exempt one party while requiring the other to pay the tax. The only differential treatment is between those who are taxed (distributors engaging in taxable activity in Colorado) and those who are not (those not engaging in taxable activities in the state). Whatever the Dormant Commerce Clause is meant to do, it is not to prevent states from taxing in-state activities. The Colorado Court of Appeals correctly applied *Armco*. Pet.'s Appendix A at 7a-8a.

III. The Question Presented To This Court Has Not Been Properly Developed In The Lower State Court Proceedings And Involves A Unique OTP Distribution Structure.

McLane asks this Court to invalidate Colorado's OTP-tax scheme and issue a decision that prevents states such as Colorado from imposing their OTP taxes on the price in-state taxable distributors pay for OTP. McLane wants this Court to do this based on an insufficient record and a unique factual situation. But because the record before the Court has not been properly developed and involves a unique OTP purchasing structure, the decision below does not merit this Court's attention.

The record from the proceedings below contains no evidence explaining why McLane does not purchase OTP directly from a manufacturer as it did prior to USTCo.'s 1990 reorganization. There is no evidence that a manufacturer would sell OTP directly to McLane for the lower price at which it seeks to be taxed. That is, there is no evidence that there exists a real market for OTP at a price any different from that at which McLane now purchases OTP from a supplier. Indeed, fundamental economics suggests that the price McLane pays is the market price for the OTP it is purchasing. But the price McLane seeks to use as its tax base is the price set by an artificial supply chain comprised of related corporate entities that buy and sell only from one another. There is no evidence that other OTP manufacturers sell their product to taxable distributors via an artificial supply chain comprised of related entities as does USTCo. Neither is there evidence that other taxable distributors purchase OTP via a supply chain comprised of either related or unrelated entities rather than directly from a manufacturer.

The record provides no evidence indicating whether the claim asserted by McLane represents anything more than a unique situation, one caused entirely by: (1) USTCo.'s corporate structure, a structure that creates an artificial supply chain intended to give USTCo. and its customers various tax advantages, and (2) McLane's inexplicable devotion to purchasing OTP at a "higher price" caused by the product's travels through this artificial supply chain.[3] The Colorado Court of Appeals correctly applied state law to prevent McLane from taking advantage of the artificial manufacture, supply, and distribution structure created by USTCo. in order to avoid fully paying the state's OTP tax. This Court should not accede to McLane's desires and issue a wide-ranging opinion based on the limited record below and the unique factual situation it presents.

IV. There Is No Conflict Among The States On The Question Presented By McLane.

McLane implicitly recognizes that there is no precedent supporting its premise that a state cannot impose an OTP tax or any other transactional tax on the actual price paid by a taxpayer for a taxable item. *See* Pet. at 14. No contradictory precedent exists because no state or other court has invalidated a similar transactional-tax scheme on such grounds. Accordingly, this Court should decline to review this case because the Colorado Court of Appeals has not decided an important question of federal law in conflict with the decision of any other state court. *See* U.S. Sup. Ct. R. 10 (b).

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[3] Furthermore, during the litigation before the Denver District Court, the Respondents conceded, for purposes of the summary judgment, that UST Sales purchased OTP from its affiliate UST Manufacturing in an arm's-length transaction. The Colorado Court of Appeals correctly noted in its opinion this concession's uniqueness when it said that a similar transaction between related entities could be conducted at less than arm's length. Pet.'s Appendix A at 3a. This unusual concession further demonstrates the limited record on which McLane asks this Court to issue a wide-ranging opinion, and makes it unlikely that any decision this Court renders would resolve the issue for future litigants.

CONCLUSION

The petition for a writ of certiorari should be denied.

Respectfully submitted,

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